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EXPORT DEVELOPMENT AND THE ROLE OF SMEs, GIVING DUE CONSIDERATION TO POSSIBLE ADVANTAGES ARISING FROM THE GLOBALIZATION PROCESS

The role of small- and medium-sized enterprises in export development

Report by the UNCTAD secretariat

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Introduction

1. The Trade and Development Board, by its decision 415 (XL), established an Ad Hoc Working Group on the Role of Enterprises in Development. According to its terms of reference, the Ad Hoc Working Group should analyse the interrelationship between the development of a domestic entrepreneurial capacity, in particular for the development of small- and medium-sized enterprises (SMEs), and the development process. Special attention should be paid to the situation of the least developed countries. Particular topics identified for analysis should include: (i) the role of the State in creating an enabling environment for the promotion of entrepreneurship and the viable development of enterprises, with reference to the regulatory framework and incentives structures, human resources development, institution building and institutional support and the informal sector and its integration into the formal economy; (ii) export development and the role of SMEs, giving due attention to the possible advantages arising from the globalization process; (iii) interactions between the development of SMEs and of capital markets and banking systems, with reference to the generation of domestic savings and access to capital markets and other sources of financing; and (iv) identification of areas where technical cooperation in support of policy development to enhance the role of SMEs could be strengthened. The Ad Hoc Working Group should provide a forum for the exchange of experiences among member States so as to enable them to draw appropriate lessons for the formulation and implementation of policies at the national and international levels and for international economic cooperation.

2. This report has been prepared by the secretariat in order to facilitate consideration of topic (ii) mentioned above. This and topic (i) will be considered at the first session of the Ad Hoc Working Group, scheduled to be held in Geneva from 3 to 7 April 1995. The remaining two topics will be considered at the second session, scheduled to be held in Geneva from 3 to 7 July 1995. The report draws on inter alia studies of country experiences, including those submitted by Governments in response to a questionnaire prepared by the secretariat from the following countries: Bolivia, China, Costa Rica, Ethiopia, Germany, Guinea, Kenya, Lithuania, Mauritius, Norway, Romania and Turkey.

3. The report raises and discusses policy issues which can be the subjects of useful cross-country exchanges of lessons learned and insights gained from national experiences, thus enabling policy elements to be drawn for the formulation and implementation of policies at the national and international levels and "best practices" to be identified. In view of the links between the four topics mentioned above, appropriate references are made, although not detailed treatment is given, of issues related to the other topics with a view of promoting an integrated output at the end of the process. These issues, together with a discussion of the nature of SMEs and of their changing role and importance in national development (see TB/B/WG.7/1), will be treated in greater detail in the other reports.

I. POLICIES FOR EXPORT DEVELOPMENT

4. Export development, as part of the process of increased participation in international trade, is an important aspect of national development strategy. Expanding export earnings facilitate structural change, alleviate debt burdens and support higher growth rates by enhancing import capacity. Growth of exports and imports increases access to the benefits of international trade. These include new ideas, technology and skills, gains from competition, economies of scale and the creation or upgrading of domestic industries around new and emerging markets. Experience shows that those countries which have maintained relatively open economies and adopted sound and consistent policies to promote export-led growth have done relatively well, and in particular have done better than those which have either over-protected their markets or failed to create a base for export-driven growth.

5. However, increasing exports through appropriate policies or policy reforms has not proved to be an easy task in many countries. The effort has required attacking the task vigorously over a sustained period from various perspectives and at different levels. At the economy-wide level, export development requires supportive macroeconomic policies, including an appropriate and stable exchange rate and sound monetary and fiscal policies in order to reduce business risks and to generate low-cost capital for investment. Both overvaluation and wide, unpredictable fluctuations of the real exchange are harmful for exports, the latter because they contribute to business uncertainty.

6. For countries which have already developed supply capacity, export development may also require trade policy reform in terms of reducing import protection and allowing exporters to have access to imported inputs at duty-free international prices, through, for example, duty waivers and exemptions from other restrictions on imported inputs or temporary admission schemes for such inputs. Such reform needs also to address the anti-export bias of the trade regime, for example, in the form of export restrictions and taxes on primary exports. In fact, export growth has been achieved by a number of countries which provide for zero or low tariffs on imported inputs and by countries such as the Republic of Korea which has applied a policy of selective or controlled trade liberalization, together with a combination of import substitution and export promotion policies. Such selective liberalization has involved a slow-track liberalization for advanced-technology products (while subjecting the industries concerned to the threat of competition) and a fast-track for internationally-competitive industries. Further, since the adequacy of the supply response to policy reforms is of fundamental importance for the long-term growth of exports, specific measures to increase supply capacity may be more important than trade and exchange rate liberalization in countries which have little or no industrial capacity, including many least developed countries. Thus, trade policy and other reforms designed to achieve economic openness and export growth, and the degree and timing of such interventions, will need to take into account the specificity of the situation of each country, including the objectives to be pursued and the level and structure of its industrial development.

7. In addition, other policy and institutional measures are needed in order to promote enterprise and export development, including the creation of a favourable policy, legal and regulatory framework for domestic savings mobilization, domestic and foreign investment and private sector development. The development of basic and other skills and of physical infrastructure is also essential. Experience has shown that manufactured exports tend to get started in developing countries with a low-cost, reasonably educated work force and that, as industries and exports develop and grow, the skill levels increase, helped by in-firm and external training and re-training programmes. Further, there is now general agreement that the availability of skilled labour, rather than low-cost unskilled labour, in a country is an important factor in attracting FDI. 1/ Good physical infrastructure, including telecommunications, power grids, ports for containerized cargo, roads and airports, is also important for exporters. At the same time, exporters need access to foreign exchange for imported inputs, as well as for marketing and services expenditures overseas. They also have some other financing needs, including ready access to pre-shipment credit for working capital and term finance for investments, which can be met by well-functioning capital markets. In addition, they benefit from restriction-free access to capital equipment and technology, as well as from investment procedures - including those governing foreign investment - which are transparent and efficient. Simplification of administrative procedures also benefits exporters, and other enterprises as well. Other services, including information on export markets and consultancy services (on productivity improvement, technology, etc.) may also be needed, although quite often private channels or market sources play an important role in providing such services. In some countries such as the Republic of Korea, the Government has also fostered the development of industries that supply intermediate industrial inputs at internationally competitive (or lower) prices. The Government may also, through appropriate policies, encourage or facilitate the internationalization of export firms by their going abroad.

8. This report examines policies and measures which foster export development in terms of the creation of export capacity and growth, and of the internationalization of enterprises, focusing on the role of small- and medium-sized enterprises (SMEs). In Section II, it looks at the role of SMEs in export development and how globalization affects that role. It also examines the role and nature of internationalized SMEs, focusing on the internationalized SMEs of developed countries from the perspective of their contribution to export development in both the home and host countries. In Section III, it examines policy initiatives and measures for supporting the export development of SMEs, including their internationalization, and draws some lessons from selected case studies on the respective roles of public institutions and private channels. In Section IV, it considers the development of niche markets, taking as an example the niche market in the United States for African goods, including so-called Afrocentric products (handicrafts and speciality clothing) as well as standardized garments. In Section V, it describes briefly some specific schemes, which have been used or encouraged for export development, including industrial districts, export processing zones, rural township enterprises and growth triangles. Where appropriate, some lessons learned from their experiences are indicated.

II. THE ROLE OF SMEs IN EXPORT DEVELOPMENT

A. Contribution to export development

9. It may be noted that SMEs already make a significant contribution to exports. In the developed countries where data on exports by size of the exporting firms are available (for example, France, Italy, the Netherlands and Norway), SMEs account for over 30 per cent of exports. In France (all sectors) and Italy (manufacturing), SMEs export almost as much as large firms. In Turkey, it amounts to 62 per cent. 2/ While there is some evidence linking export performance or the export/sales ratio to size (for example, in France, the Netherlands and Norway), the evidence is not conclusive. In Italy, SMEs in industrial districts are major exporters. As for Japanese SMEs, there has been a decline in their exports, probably linked to the dramatic appreciation of the yen since the 1980s. Although their share of total exports is still small in the developed countries, the rate of growth of SME exports is growing faster than that of larger firms.

10. In the developing countries for which such data is available, the shares of SMEs of total export earnings seem to be higher. In the Republic of Korea and Taiwan, Province of China, their shares amount, respectively, to 40 per cent and 56 per cent. 3/ In China, they account for more than 50 per cent. For the developing countries of East Asia as a whole, it is estimated that SME exports account for about 40 per cent of their total export earnings, twice the OECD rate for SMEs. Further, the rate of growth of SME exports is higher than the growth of total exports. 4/

B. The Impact of globalization

11. Globalization of production and inter-firm networking is taking place through the geographical dispersal of industrial activities (for example, R & D, outsourcing of inputs, production and distribution) and through the creation of inter-firm networks (as manifested, for example, in inter-firm alliances, joint ventures and assets sharing). Such a process presents various export opportunities for SMEs. SMEs not venturing abroad may establish links with other firms in order to supply export markets through, for example, subcontracting, joint marketing and franchising arrangements. Those going abroad can establish affiliates, joint ventures or alliances with other firms in order to penetrate foreign markets. By exposing their products to new markets, they can hope not only to increase the levels of sales and employment, but also to prolong the life cycle of their goods and services. It also allows them to test their products in a variety of markets in order to improve their quality, as well to achieve scale economies. However, globalization of networking and production also brings with it the globalization of competition, which puts pressure on SMEs to increase their performance in order to survive in the international marketplace. There is thus a constant pressure to innovate, to find and develop niche markets and to establish long-term cooperative relationships with other firms in a competitive environment.

12. SMEs in fact have a stronger reason than large firms to establish alliances with other firms. While they are more flexible and more adaptable, and thus more responsive to new opportunities, they often have constraints related to the availability and cost of capital. Forging alliances with other firms allows them to share risks and to pool resources, as well as to boost their standing in their particular industrial segment or sector, thus adding value to their brand names. In addition, by creating alliances, they can penetrate international markets or accelerate market entry by using host partner's sales force, distribution network and knowledge of local markets; broaden product line or fill gaps in product line; gain a foothold in emerging industries; join forces in order to solve technical problems; lower manufacturing costs by exchanging technology and sharing production facilities, manufacturing process experience and R & D costs (including through outsourcing) and improve capabilities through learning from partner's skills.

13. In the current context and under the impact of globalization, SMEs may export in any of the following ways: by direct export to foreign markets; exporting through a trading company; exporting in association with another domestic firm through subcontracting arrangements; exporting through joint marketing networks or franchising arrangements with foreign firms; exporting by creating alliances with foreign firms with local majority ownership or through joint ventures; and exporting by creating affiliates in foreign countries. The last two involve internationalization in the strict sense of the term, i.e. they involve SMEs going and investing abroad. While some SMEs in developing countries are internationalizing themselves, they are still in a minority compared with the internationalized SMEs of developed countries. In any case, they are not well-documented and further research is needed.

14. For SMEs in developing countries, and their Governments, the lessons are clear. Their SMEs need to be players in the new configuration of alliances or networks. As home-based exporters, they can produce for direct export by teaming up with foreign firms in order to supply export markets. They can together create clusters of inter-firm linkages, as in an industrial district, to achieve economies of flexible specialization in order to compete in international markets. The Governments can create export processing or special economic zones and promote export production villages as export bases, with the help of foreign investment, including from foreign internationalized SMEs. They can also create growth triangles linking contiguous economic areas with neighbouring countries to pool and exploit joint resources for export development. As internationalized SMEs, they can enter into alliances or joint ventures with foreign companies in order to penetrate foreign markets. For these things to happen, the SMEs will have to learn to produce for the export markets and to think and act international, cooperating and competing with other firms at the same time. At the same time, Governments have to create a favourable macroeconomic, policy, legal and regulatory environment for enterprise and export development (see Section I above). Governments may also have to help exporting SMEs, through appropriate policy initiatives or support programmes, to overcome constraints to their export or internationalization efforts (see Section III below).

C. Internationalization of SMEs

15. While the internationalized SMEs of developed countries are quite well-documented and have been the subjects of a recent survey undertaken by the United Nations, 5/ much less is known about the internationalized SMEs of developing countries. This section will thus focus on the internationalized SMEs or the SM TNCs of developed countries. According to the results of the above-mentioned survey, SM TNCs of developed countries tend to be larger than the average SME. Over 90 per cent of such TNCs are involved in exporting, although their efforts tend to be concentrated in other developed countries. Exceptions are Japan and Australia whose SM TNCs are particularly active in South-East Asia.

16. SM TNCS expand abroad for a number of reasons. One of them is to increase the size of their markets. Strong export potential of a region also counts; this has been an important factor, for example, for European SMEs investing in South and East Asia. Low-cost (reasonably-educated) labour in the host country is another reason, since they are usually involved in labour-intensive activities. For many, protection in overseas markets, especially countries with import-substitution policies, is an additional attraction.

17. Maintaining foreign market shares also emerges as another factor. Foreign ventures may appear to be a measure of last resort, reluctantly undertaken by SM TNCs, in order to protect their markets. Alternatively, they may invest abroad in order to supply their clients (both domestic and foreign) from low-cost locations, as with Japanese SMEs established in South-East Asia. Further, SMEs may internationalize as a result of following their customers abroad, for instance the Japanese SMEs in the auto components industry who followed major transnational automakers to new operations in the United States. SM TNCs may also set up affiliates in response to initiatives from local firms; such a "pull factor" seems to be more important for them than for large firms. The tax structure and Government incentives can also have a pulling effect, although the latter seems to be relatively unimportant for SM TNCs when internationalizing.

18. SM TNCs operating in developing countries are particularly involved in textiles, chemicals, mechanical and electrical equipment. The small-scale, labour-intensive technology of SM TNCs is usually more suitable for developing countries. They do relatively well in the transfer of technology, but slightly less well in adapting technology to suit the nature of local demand, local raw materials and local labour. This may be due to inferior levels of technical mastery, lack of resources, shortcomings in local personnel or to the fact that more suitable technology was already transferred in the first place. As they are more export-oriented than large TNCs, they may have a positive effect on the balance of payments of the host country. They are more likely than large TNCs to use developing countries as a base for exports. High technology industries are the biggest generators of foreign exchange - affiliates of SM TNCs in such industries have a 94 per cent export/sales ratio. In addition, due to the nature of SME internationalization and their relatively limited financial resources for investment, they tend to develop more linkages with the local economy through joint ventures.

19. For developing countries, and countries in transition, SM TNCs seem to offer some advantages in terms of increasing their technological capabilities and their export capacity. They are more likely to enter into joint ventures with local firms, and to give local firms access to new technology and skills. However, joint ventures are more likely to take place in medium-technology rather than in high-technology industries. (In the latter case, SM TNCs tend to prefer the setting up of affiliates in order to protect their proprietary technology.) Whether this is the "appropriate" technology depends on the level of development of the host country and on local capabilities. As SM TNCs are more export-oriented, they can help the industries concerned in host countries to build up export capacity. They are also more labour intensive. However, to tap these advantages of acquiring new technology, expanding supply capacity and export markets, the presence of basic skills for the shop floor and of capabilities for mastering (and adapting) technology are essential. The lack of basic skills can affect the quality of goods - an important factor in exporting, and thus for the investor which wants to build up export markets. Thus, in attracting SM TNCs, the presence of certain basic skills is a necessary condition, in addition to other factors such as political and economic stability, the openness of the economy and a favourable policy, legal and regulatory environment for private sector development and foreign investment. The latter may include investment incentives to attract foreign investment. Other "incentives" include domestic market potential, a suitable export base, regional trading arrangements and adequate domestic sourcing. Good infrastructure is also an important factor, and this may be more so for SM TNCs since they do not have the same resources as large TNCs, which can sometimes surmount difficulties in this area, for example, by building a road where necessary or by installing their own communication lines.

III. POLICY INITIATIVES AND MEASURES FOR SUPPORTING THE EXPORT DEVELOPMENT OF SMEs

A. Policies for the promotion of export development of SMEs

20. Supporting the export development or internationalization of SMEs requires first of all the establishment of a favourable policy, legal and regulatory environment for enterprise development, as well as appropriate policy and institutional support for SME development. All this has been discussed in another document entitled "Creating an enabling environment for the development of enterprises, particularly small- and medium-sized enterprises" (TD/B/WG.7/2).

21. In addition to the broad measures mentioned above, certain other specific support measures may be needed for promoting the export development or internationalization of SMEs. Producing for export markets exposes firms to the rigours of international competition and to the workings and demands of the international marketplace. Basic information about potential markets - general and business culture, consumer preferences, packaging and quality standards, market potential, capabilities and product lines of competitors, the retail system, the relevant trade measures, the legal and regulatory environment, domestic sourcing, etc. - is essential. Inter-firm networks need to be extended to foreign firms, whether in production, marketing, retailing or in the provision of business support or other services. A strategy has to be defined for securing market entry and establishing market credibility. Possibilities of export financing and export support services have to be explored. And problems identified need to be solved.

22. The availability of support in the way of credit facilities, information, advice or technical assistance can make a critical difference in overcoming constraints or in creating confidence, particularly for those new in the business of exporting or of branching out abroad. Some such support might have to be provided by public institutions, for example credit facilities and guarantees; other kinds of support, for example market information, might be provided by partner or associated firms through inter-firm or market networks. Some Governments are much more active than others, depending on their policy objectives and their own role vis-à-vis the private sector. Depending on the nature, strength and efficiency of inter-firm networks, some Governments may feel it necessary to adopt a more active policy stance in order to compensate for perceived market deficiencies.

23. The following table shows how different policy initiatives or measures in support of SME development may be given an international dimension in order to support the export development or internationalization of SMEs and provides examples of how they have been applied to a lesser or greater extent by countries in the Asia-Pacific region.

Table 1. How domestic SME policy may be internationally-oriented

Initiative	International orientation	Examples
Management training	Encourage international perspective and competence	Malaysia (use of foreign expert executive services) China; rural township enterprise training programme
Relations with large firms	Encourage SME linkages with larger international firms	Indonesia; linkages programme
Business advisory	Consultancy service to SMEs needing specific advice on internationalization	Most countries
Finance	Grants, guarantees, incentives for exports or investment	Singapore; overseas enterprise incentive scheme
Technology transfer	Industry technological upgrading to international standards	China; Spark programme assists rural SMEs with better technology
Technology R & D	Encourage international use and development of R & D	Republic of Korea; low-cost loans for technology imports and R & D
Coordination of programmes	Single coordinating point for policy implementation; "one-stop shop" for SME inquiries	Singapore; multi-agency approach
Regionalization and decentralization	Encouraging SME development overseas	Singapore; overseas industrial parks
Regulatory simplification and coordination	Attempts to use the same regulations in other countries	Harmonized customs systems; some growth triangles
Market promotion	International trade fairs, trade missions, expositions, etc.	Most countries
Market research	Trade and market information services; trade missions	Most countries
Tax concession	Relief from domestic VAT for exports	China, Singapore and most other countries
Business infrastructure support	Incubators and industrial parks aimed at international SMEs	Malaysia, Thailand; industrial parks, incubators
Networking	International matching services, joint ventures	Singapore; joint ventures, matching data bank

Source: Dr. Chris Hall, University of Technology, Sydney, Australia in a paper on "The globalization of economic activity and SME development in the Asian economies; evidence and policy issues" presented to the 21st International Small Business Congress, Jakarta, 18-21 September 1994.

B. Some case studies of support for SME export development in developing countries

24. A recent ITC study of the constraints facing exporting SMEs of four developing countries in the Asia-Pacific region (Bangladesh, India, Indonesia and Pakistan), based on an in-depth survey of selected SMEs in these countries, points to the importance of public institutions and business organizations in providing support services to exporting SMEs. 6/ It also points to the role of inter-firm channels and market networks in certain areas, for example marketing for the first export phase of penetrating foreign markets and information needs, areas where weaknesses of existing public support systems have also been identified. The study examines certain constraints faced by exporting SMEs and makes a number of recommendations, including some addressed to public support institutions. These may be summarized as follows:

(a) The major constraints facing SMEs continue to be in the three critical areas of finance, technology and markets; on finance, export financing mechanisms need to be improved, including the establishment and enlargement of pre- and post-shipment credit facilities and guarantees, export credit guarantees, insurance and exchange rate cover; on technology, the support system for promoting the acquisition of technology and strategic business alliances is weak, and the staff needs to be trained in order to take a more pro-active role in needs assessment for such alliances, preparation of cooperation proposals, partner search and negotiation of cooperation agreements; on export development, the most difficult is still the first export phase of securing market entry and establishing market credibility and, due to lack of institutional support, it invariably depends on personal contacts; export processing zones, export trading houses, export production villages and the like have to be operationalized, wherever appropriate, for providing marketing solutions to small production and export volumes of SMEs, while more developed SMEs with higher export volumes need specialized training in export management and marketing, as well as in other technical skills essential for export operations, such training to be adapted by means of different modules to different situations;

(b) A more structured system of consultation, with a greater involvement of SMEs, is needed in the process of designing policy options, procedures and incentives schemes, and in order to facilitate the translation of policy into positive results;

(c) The information needs of exporting SMEs are met mostly from personal contacts and informal sources; rather than flooding their clients with unwanted data, which SMEs do not have the time and energy to digest, the agencies concerned should provide them with very specific product and market information related to their line and volume of production and their comparative advantage in a timely, relevant and comprehensible manner;

(d) Exporting SMEs are increasingly conscious of the need for quality and for paying greater attention, and providing greater resources, to technological upgrading and quality management in order to enhance their product image and competitiveness; while they are paying increasing attention to in-process and end-product quality control, very few of them are able to

afford individual quality testing of inputs; they would prefer paying for such a service provided by a common facility centre, which can also provide quality certification, packaging and labelling advice and services, as well as tool room facilities; further, they need reliable, steady and uninterrupted supply of power as an essential input for the production of high-technology and high-quality goods, as well as improved access to telecommunications services which, in addition to being an aid to business management, can cut down considerably their cost of going global;

(e) Import procedures remain cumbersome and costly on account of the various formalities needed; where import consignments are small, pooling arrangements can help to reduce costs (by as much as 25 per cent); common warehousing arrangements at home and in selected market areas can help to reduce operational costs and the time of response to market inquiries;

(f) SMEs are willing to pay for good, comprehensible advice specific to their needs and do make good use of private consultants;

(g) None of the bodies involved - SME development agencies, trade promotion organizations, chambers of commerce, trade and industrial associations, etc. - offers the entire range of services needed by exporting SMEs, although each one has its own areas of strength; role allocations based on the identification of lead agencies would increase the effectiveness of delivery;

(h) Activities which need strengthening include: identification of focal points for articulating SME problems to policy makers and establishment of continuous Government-business dialogue; training in export marketing techniques and management, financial management and costing and pricing; promotion of business cooperation arrangements for marketing, production and technology transfer, with or without equity participation; establishment of a reliable and prompt information service capable of providing individual enterprises with information of immediate relevance; organization of pooling of imported raw materials and other inputs; establishment of common facility centres; provision of niche marketing assistance to individual enterprises; further, the capabilities of trade and industrial associations to provide such services should be strengthened.

25. Two recent World Bank studies examined the role of SMEs and their support systems in the export success of the Republic of Korea and Indonesia. The studies, based on a sample of SMEs in selected sectors in each country, indicate that, in the area of export marketing, private channels (buyers and agents) rather than public support systems have been the most important source of help to SME exporters, both at first export and current operations. The more highly rated services provided by public institutions are those that are specific in character such as participating in trade fairs and obtaining foreign standards. In Indonesia, private channels have been the dominant source of technological capability for SME exporters, although support by public institutions for the use of private technical consultants is highly valued. Likewise, in the Republic of Korea, both buyers and suppliers have played major roles in extending help to SMEs in the area of technological innovation. "Learning by seeing" (at fairs and other factories) is also considered to be an important mechanism for reverse engineering of existing

products. Public technical support institutions are quite frequently used, but their role is being eroded as technology and its rate of change are becoming increasingly important. Public technical information centres are rarely used and not highly valued. 7/

C. Support measures in developed countries for the internationalization of SMEs

26. In the developed countries, different types of institutions have been set up, aimed at promoting the internationalization of SMEs, particularly to developing countries. Among them are development finance corporations that participate as equity investors in projects in developing countries, offer loans and guarantees for such projects, implement feasibility studies for the projects proposed to them, and furnish basic information on host countries and potential project partners. 8/ Other financial organizations, some of which specialize in helping SMEs, provide help through loans or guarantees, including insurance against political risks in developing countries. 9/ In addition, there are technical organizations which run development assistance or technical cooperation programmes in developing countries. Some of them are specific to developing countries. Some others deal specifically with the promotion of SMEs by supplying them with technical assistance, information and training. 10/

27. Six types of services provided by the different types of institutions can be distinguished. One, basic information services which are not directly related to the implementation of a given project, including awareness services, designed to help SMEs enhance their awareness of profitable opportunities in developing countries for their particular assets and data banks providing information on potential partners in developing countries or of a more general nature concerning the political, economic and business environment of individual developing countries. Two, pre-project assistance, including provision of market information and assistance in the identification of suitable partners in developing countries. Three, project assistance and management, including the financing of feasibility studies and the provision of legal advice. Four, financial assistance, including through loans (usually viewed as co-financing instruments) and guarantees. Five, special financing initiatives, including contributions to costs of installation, adaptation of technology and of local training. Six, investment guarantee services, including export credit guarantee and insurance against political or other risks.

D. Supporting activities of international organizations and donors

28. International organizations and the donor community also undertake activities for supporting the export development of SMEs. In this connection, as examples, reference is made below to the activities of UNCTAD's Trade Efficiency Programme and the export promotion activities of the International Trade Centre, as well as to an Indo-German inter-firm networking project supported by a German technical cooperation agency.

29. The Trade Efficiency Programme of UNCTAD consists of establishing, operating and interconnecting trade points worldwide. Trade efficiency and the trade points are a tool to allow SMEs to internationalize by becoming competitive exporters and better importers. In particular, it allows SMEs to work directly with other SMEs in their regions and in other regions. Locally, this allows SMEs to acquire the critical mass which will enhance their bargaining power as well as their ability to access certain trade-related services (banking, insurance, transport, telecommunications, etc.). At the international level, trade efficiency and the Global Trade Point Network allow SMEs to benefit from direct access to trade-related information (on products, markets, prices, but also on regulations and statistics for example) and to expand their activities in international markets.

30. The International Trade Centre UNCTAD/GATT has a major technical cooperation programme in the field of trade promotion and export development. Its basic objective is to help developing countries in the development of their export capacity by assisting them in formulating trade promotion strategies and in establishing or strengthening appropriate institutions and export support services. Activities carried out under this programme are focused in particular on exporting SMEs and are designed to address the major constraints to export expansion by developing countries' exporting enterprises. The services offered include: trade development strategies and programmes at the national level; institutional infrastructure for trade promotion and export development; technical cooperation with chambers of commerce and industry and other business organizations; national commercial representation abroad; export finance services; export project development, and costing and pricing; legal aspects of international trade; export development of small and medium-sized enterprises; export-oriented joint ventures; export packaging; export quality management; and trade promotion communications.

31. Donors can also play a role in promoting inter-firm networks for export development. As an illustration, reference may be made to the Indo-German Export Promotion Project (IGEP), supported by GTZ, the German technical cooperation agency. The project brings Indian firms into closer touch with the German market by providing market information, organizing marketing seminars and arranging participation in trade fairs in order to familiarize them with the demand conditions and the capabilities of competitors. Support by the project's consultancy services is concentrated on a selected "core" group of companies which are assessed to have the potential to meet the demand conditions in German and European Union markets and to hold their own after receiving initial support. Other "core" companies selected from a "second circle" will replace those who no longer need support. There is also a "third circle", to which all the Indian companies are entitled to belong and which is supplied with basic information about the German market.

32. The project focuses its support on certain product groups, selected on the basis of certain criteria, including whether or not there is existing or potential demand for a particular product. Such support can help exporters of traditional products like shoes, silk garments, leather goods and gold jewellery to penetrate highe. quality product segments and thus to increase the Indian share of value added. It can also help to build up closer cooperation and supplier relationships between Indian and German firms in

technology-intensive products such as computer software, automobile and bicycle components and castings. The creation of such relationships, particularly on a long-term basis, helps Indian firms to establish themselves in German markets. Exposure to competitors and new market conditions spurs Indian companies to improve their performance and competitiveness. Through the project's activities in the fields of trade fair promotion, design and product development in conjunction with a limited number of Indian exporters, a new awareness is created among leading German importers and traders, which can lead to closer cooperation, including supplying Indian companies with latest information about designs and trends. For example, the resulting substantially greater interest in Indian gold jewellery has led to a rapid increase in the number of gold jewellery producers in export processing zones in India. Apart from promoting business contacts and cooperation, which can generate new processes and activities, as mentioned above, the project also serves to transfer know-how through not only export promotion institutions but also imitation processes among exporters, serving to disseminate successful exporting practices. By maintaining an economic policy dialogue with official policy makers, the project can contribute to improving the policy and regulatory environment for Indian exporters. And by working directly with firms which provide feedback to Governmental institutions and private sector business organizations, and by indicating what types of export promotion activities are appropriate or possible, the project can contribute towards a bottom-up approach to institution building. 11/

IV. DEVELOPMENT OF NICHE MARKETS - AN EXAMPLE

33. This section gives an example of a niche market that may be developed for the promotion of export growth. In a study undertaken by the World Bank entitled "Africa can compete" 12/ it is argued that there is a significant niche in the United States market for African products, first of all for so-called Afrocentric products (handicrafts and speciality clothing) but more importantly for standardized garments, particularly those for which quotas make Asian suppliers relatively expensive. It has been estimated by the World Bank that supplying just 1 per cent of the American market alone would yield $275 million of garment exports a year - more than 10 times what the major Sub-Saharan African countries are now exporting in the garments sector. The findings of the study have important implications for the development of Africa. To the extent that Africa can compete, the study suggests that foreign investors, trading companies and buyers - all of which have proved to be important partners for development in Asia and Latin America - have a larger role to play than earlier envisaged.

34. The study, involving case studies of a number of major United States retailers and of suppliers in five African countries (Côte d'Ivoire, Ghana, Kenya, Senegal and Zimbabwe), covered three categories of products: Afrocentric garments, Afrocentric home products and mainstream garments. They indicate that a niche market in the United States has emerged for African manufacturers, helped by the growth in numbers (and wealth) of African Americans and their more favourable response to products that address their ethnic heritage, that African designs are "hot" and that United States retailers are scrambling to source products in Africa. Further, African producers are becoming competitive in the production of standardized garments, their costs comparing favourably with other production centres, for example in India and the United Arab Emirates. In well-managed factories, this competitiveness is derived from low labour costs, competitive task-level efficiencies and the quota-free status of nearly all African countries.

35. However, although several international garment manufacturers have set up or are setting up plants in selected African countries, retailers have begun sourcing garments, large buyers have set up offices to identify potential suppliers, problems have arisen. They have not been due to insufficient demand but to the inability of African producers to supply adequately, due to both enterprise-level and macroeconomic constraints. At the enterprise level, most of the supply problems emanated from the mismatch between United States buyers needing large volumes and adherence to strict delivery schedules, and small African manufacturers with little exposure to exporting or United States business culture and experiencing problems in meeting quality standards, packaging and the coordination of input supply.

36. Given the importance of the potential of the niche market in the United States in terms of generating export earnings, jobs, inter-firm linkages and other benefits and of creating a base for further industrialization (as illustrated, for example, by various East Asian economies such as Hong Kong and Taiwan, Province of China), African Governments would seem to have a strong interest in addressing both the enterprise-level and macroeconomic constraints in order to develop the niche market. This effort would require taking a number of steps as a matter of

high priority. As the World Bank has suggested, they include: (i) making capital more easily available so that firms are able to meet large orders immediately and eventually update their technology; (ii) improving capabilities of managers so that they are better equipped to confront the tougher competition of the international marketplace; (iii) ensuring better access to information, particularly concerning the nature and complexities of foreign retail systems; and (iv) ensuring that technical assistance is provided for on-site training in, for example, production methods, quality control and technical craft skills. At the same time, Governments have to address the macroeconomic constraints which inhibit the development of the export industry, including questions like import restrictions on raw materials, foreign exchange availabilities for exporters who earn foreign exchange and infrastructural deficiencies, for example in respect of telecommunications and ports.

37. The World Bank study refers to the experience of Associated Merchandise Corporation (AMC) with Kenya, which shows that successful export programmes are possible even with various infrastructural and enterprise level constraints. AMC has been successfully importing home products from the various manufacturers in Kenya through the intermediary of a Government institution, the Kenya External Trade Authority. The relationship began in 1976, and almost a decade was spent in improving the skills of exporters and building up their credibility as efficient suppliers of quality merchandise. The exports of handicrafts have since expanded. The study of the relationship provides a number of lessons concerning key factors in a venture's success, including: an interested buyer, the availability of diverse products, the Government's commitment to the venture's success, realistic assessment of production capabilities, foreign technical assistance, graduated scaling up of orders and reasonable infrastructure and communications links. It has also important implications for the role of the Government in artisan product exports. For example, in the absence of other commercial intermediaries, large buyers look to the Government to provide basic support functions. In this case, the Government, with donor support, worked closely with the buyer. Such lessons learned may be applicable elsewhere in Africa.

V. SOME SPECIFIC SCHEMES FOR THE DEVELOPMENT OF EXPORT CAPACITY

38. This section looks at examples of specific schemes that have been promoted to develop export capacity. Three of them - industrial districts, export processing zones and the rural township enterprise system - are national in character. By contrast, the fourth example - growth triangles - straddles national boundaries. While it has been chosen for its particular interest, it is recognized that there are other examples, including integration groupings. However, their role in promoting the export development of SMEs would require further research.

A. Industrial districts

39. An industrial district is a clustering of a large number of SMEs working in a single industry in a distinct geographical area, connected by strong societal and cultural links (religious, political, ethnic or springing from a commonly-shared experience) among the workforce that enhances trust and facilitates inter-firm cooperation. Each of these firms specializes in one aspect of the production of a good or a family of goods (thus achieving sectoral specialization), allowing firms to concentrate their resources and make technological progress that would have been impossible had they been obliged to cover all areas of production. It is this kind of specialization-defined division of labour based on inter-firm cooperation that allows them to achieve flexible specialization and distinguishes them from informal economies which have many of the same characteristics, but which have not had the same economic success. Industrial districts have in general grown spontaneously from local initiatives, driven by a combination of entrepreneurial energy and skills specialization, developed either informally or formally. These skills are constantly upgraded as they respond to new market demands; their exposure to overseas markets adds further pressure on the firms and workforce to innovate and to improve their skills and helps in fact to contribute to their dynamism. Specialization enables individual firms to achieve scale economies at the plant level. As they develop, workers acquire multiple skills and firms invest in multi-purpose machines. All this allows them, by working together, not only to achieve economies of scale and scope similar to large firms but also to deepen their specialization and to offer a wide range of products. Further, their large number in a particular geographical area gives rise to high-density externalities. They seem to be particularly suited to the challenges and opportunities brought about by the process of globalization, with its trend towards the outsourcing of specialized production inputs or services.

40. **Contribution to export development**. Industrial districts offer the possibility of achieving technological innovation and higher quality products, suggesting a significant contribution to export development. There is evidence to suggest a correlation between process specialization and exporting. For example, in the rattan furniture district of Tegalwangi in Indonesia, subcontracting activity within the district's SMEs has been encouraged by the large exporting firms outside. The export-oriented SMEs, like those in Santa Croce, Italy, tend to be more process-specialized, with better technological capabilities and higher quality products. They also generally offer higher wages and better working conditions. Other examples of industrial districts that are primarily export-oriented include the diamond

polishing clusters of Tiruppur and Surat, India, the furniture-making district of Brianza in Italy, and the footwear clusters in Sinos Valley, Brazil and Trujillo, Peru. However, there are also industrial districts in some developing countries which tend to concentrate on local demand, away from the higher-income export market.

41. **Inter-firm cooperation.** Inter-firm cooperation varies greatly depending on the nature of the product market and the possible gains from such cooperation. Cooperation can take place vertically, horizontally or diagonally. Vertical cooperation is perhaps the most common form of inter-firm relations. By breaking down and sharing out the various stages in the process of manufacturing a product, a firm can become more technologically adept at its particular task, invest more heavily in specialized tools and machinery and gain economies of scale. In the leather-producing district of Santa Croce, Italy, at least half of the 15 to 20 phases in the production of leather are subcontracted out to specialist firms. This has proved the most efficient method of reducing costs, at the same time allowing each enterprise a certain flexibility in production that constitutes the core of the industrial district system, namely flexible specialization. In the rattan furniture cluster in Tegalwangi, Indonesia, there is a strong practice of subcontracting, usually initiated by large exporting firms. The latter enforce deadlines and quality standards, and later handle the finishing, packaging and marketing aspects, while the SMEs manufacture specific components or complete a particular process. These SMEs might themselves subcontract labour-intensive processes (such as the weaving and tying of the rattan) to home-based workers. Likewise, in the garment district of Gamarra of Lima in Peru, inter-firm vertical cooperation has led to worker specialization and the acquisition of specialized machinery.

42. Diagonal cooperation takes place between firms which do not compete for the same market but which coordinate to manufacture complementary products. Such cooperation might involve the sharing of common facilities or the use of a common design pattern. Horizontal cooperation, such as the sharing of large orders, periodic collaboration or periodic subcontracting, is rarer, as this involves cooperation between producers of the same product. However, this form of cooperation enables small firms to compete with larger firms for big orders. Horizontal cooperation can also lead to networks of tool and machinery sharing, giving small firms access to more advanced, more expensive machinery which they would not have been able to afford on their own. In the Indonesian roof tiles sector, horizontal cooperation has allowed firms to pool their resources to buy sophisticated mixers and enjoy economies of scale. In more export-oriented districts such as Santa Croce in Italy, SMEs have jointly hired export consultants to advise them. Another possibility for this type of inter-firm relations would be the joint establishment of storage facilities and R & D centres or the handling of environmental matters (recycling processes, waste treatment facilities, etc.).

43. Information-sharing is a crucial part of inter-firm relations. This can be undertaken in the form of informal, personal communications or formalized networks such as business associations. The information shared is of two types, "general" information (regarding production or market factors) that does not give a firm any special competitive advantage and is therefore shared with all in the district, and "particular" information that is not openly shared.

44. Large-small inter-firm relations can be of two types. In mutually beneficial relations, the larger firm passes on technological information and training to the small firm in order to attain a reliable and consistent supply of high-quality products. This relationship is usually non-hierarchical, with a high degree of diffusion of technology and skills. On the other hand, if the large company simply wishes to cut production costs and reduce its risk by subcontracting to smaller firms, the resulting relationship is often hierarchical, impersonal and transient in nature, with the smaller firms facing a higher degree of risk. Both types of relations can be seen in the Republic of Korea in the automobile district of Ulsan and the textile district of Daegu.

45. All these types of inter-firm cooperation contribute to the achievement of flexible specialization by which a firm can respond quickly to market demands. Subcontracting between SMEs and between SMEs and large firms enables SMEs to become more process-specialized. Technological diffusion from larger firms and through information networks gives SMEs the technological capacity to achieve flexible specialization, while the support structure of an industrial district encourages the sharing of machinery and skilled labour. Altogether, this permits the SMEs of industrial districts to adapt quickly to market demands, giving them a competitive edge. All these forms of inter-firm relations can be seen in Santa Croce, Italy which buyers come to know because "any manner of product could be made at the drop of a hat in Santa Croce". 13/

46. **Lessons learned.** Case studies of the development of industrial districts in developed countries suggest that they sprang from local initiatives rather than from any State, regional or local policies. Two phases of their development have been identified, spontaneous growth and institutionally-enhanced growth, the latter involving many local business associations, which have resulted from local initiatives and which are - at least partially - self-financed. 14/ Likewise, the development and growth of industrial districts in developing countries have been largely due to local initiatives, including those of local business associations.

47. However, despite the original impulse of industrial districts, the public sector can play a role in enhancing their growth. At the central level, the Government can help in a number of areas to the extent that such assistance is needed in order to complement inter-firm or market networks, such as management training, finance, information and technical assistance. Charges for services provided should be made, which will help to establish the value of the services and allow the Government to update them continually. Examples include the services provided by the Small Business Advisory Bureau in the Philippines, including consultancy, research, product and process development, management training, financial planning and marketing advice, and the

Subcontractor Exchange Programme in Malaysia, which keeps a detailed database of vendors and subcontractors in various industries in order to facilitate inter-firm linkages. Such services are of course generally available to all firms. The Government can also set up specialized institutions to develop technology and diffuse it to SMEs. For example, in Singapore, the Government, in addition to setting up tertiary institutions in the geographical area of its industrial district, has also set aside S$ 400 million through the National Science and Technology Board (NSTB) to increase the supply of research scientists. Furthermore, the NSTB encourages R & D by offering to fund up to 70 per cent of the total direct cost of R & D projects. Under another scheme, the NSTB funds up to 50 per cent of costs directly associated with product development. 15/ The Government can also help by providing adequate infrastructure, such as roads, railways, telecommunications, water supply and electricity and by reducing bureaucratic red tape through, for example, the creation of a single agency for issuing licences and permits.

48. Regional and local Governments may be given more incentives to promote the success of industrial districts in their areas, for example by channelling tax revenue from industrial districts to regional or local authorities. The importance of regional bodies is illustrated by the regional council of Emilia-Romagna in Italy, which has established the Textile Information Centre. The Centre has had a profound impact on the industry by supplying information regarding fashion trends, technology and marketing. It is suggested that where services can be provided by regional and local institutions, they may even have certain advantages over central institutions in the sense that they tend to have more accountability. 16/

49. Like those provided by public institutions, services provided by enterprises and their associations may range in efficiency and usefulness, although in general sectoral and business associations have often proved more competent than government initiatives in establishing support networks. Business associations often provide services such as organizing trade fairs and expositions, consultancy work and political lobbying. Trade fairs are an important part of the process of "learning by seeing" that characterizes the SMEs in industrial districts. They also provide an opportunity to reinforce inter-personal links. Firms grouped together in associations are also in a better position to arrange access to credit at below market rates and can coordinate the joint purchase of machinery and other large investments. One successful organization is the Cámara del Calzado (the Mexican footwear organization) which provides finance through credit unions and a range of services. It has even set up a training institute in Guadalajara. The local sectoral associations in Santa Croce in Italy serve to underpin the system of mutual interdependence that has developed, in addition to disseminating information and knowledge throughout the industrial district. Another role of business associations is to formalize the exchange of information and cooperation by maintaining lists of members seeking industry-related services, arranging subcontracting among members and publishing trade journals. Business and trade associations are more likely to be influential at the later stages of the development of an industrial district when business practices tend to be more mature and formalized.

50. The informal economies of developing countries exhibit many of the same characteristics as industrial districts (clustering, artisan traditions, adaptability and flexibility and a strong sense of local identity) but have not achieved the same economic success. What is lacking seems to be a local support system that individual entrepreneurs can draw on in order to overcome their isolation. For example, certain SME clusters beginning to develop in Africa, especially in the woodworking sector in Kenya, Sudan, United Republic of Tanzania and Zimbabwe, are at a disadvantage in terms of technology due to an absence of inter-firm cooperation. Thus, it seems more likely that flexible specialization will emerge in the more modern large-scale firms. 17/ Further, in the industrial estates of Burkina Faso, "there is little subcontracting, technological innovation or innovation diffusion. Neither do government policies stimulate these developments". 18/ Accordingly, it has been suggested that "what is required is not an upgrading of firm-specific attributes but of the milieu underpinning entrepreneurship". 19/ This supporting framework can be achieved by fostering firm specialization, promoting vertical and horizontal cooperation, organizing trade fairs to advertise the region involved and strengthening existing technical institutions and vocational training programmes.

51. The abundant supply of labour to be found in many developing countries (often with minimal labour regulations) poses a particular problem to their budding industrial districts. The possibility of exploiting cheap labour and gaining a competitive advantage through cost-cutting is a disincentive to technological innovation, creating a disadvantage for the country in the long run. Thus, government policy in developing countries seeking to enhance their industrial districts should concentrate on fostering inter-firm cooperation and building up basic and other skills in order to promote increased specialization, technological improvement and a system of mutual interdependence in them. As production efficiency and quality rise, there is normally a shift towards producing export-oriented goods, in addition to raising wages and improving working conditions. The success of an industrial district lies in inter-firm cooperation and flexible specialization; this is the main lesson to be drawn from the experience of industrial districts in both developed and developing countries.

B. Export processing zones

52. At present, there are about 170 export processing zones (EPZs) in approximately 60 developing countries, providing nearly 1.8 million jobs. If the seven special economic zones (SEZs) in China are added, the total employment figure amounts to nearly 4 million. Additional EPZs are being planned for at least 20 more countries. 20/ To give an order of magnitude, EPZs are responsible for over 60 per cent of new manufacturing jobs created in Malaysia and Singapore since 1970, and nearly all such jobs created in Mauritius. As regards their contribution to exports, EPZs in Mexico generated 53 per cent of manufacturing exports and 35 per cent of total exports (1989). EPZs in Mauritius accounted for 96 per cent of manufacturing exports and 65 per cent of total exports (1990). In the Dominican Republic, these figures stood at 51 per cent and 43 per cent respectively (1989). 21/

53. While the concept of EPZ has been somewhat controversial, the proliferation of EPZs would seem to indicate that they have met some of the expectations of the host countries. In terms of its main objective, that of attracting FDI, there is undeniable evidence that EPZs, although relatively small as a sector, have been among the most dynamic sectors in attracting such investment, especially in recent years. The downside is that foreign investors, because of their size, have a decisive influence in shaping the industrial structure of EPZs (dominated by textiles and garments and electronics assembly). Although EPZs have been criticized for the type of employment they create (mostly unskilled or semi-skilled) they have provided jobs for a section of the population who would otherwise not have had the opportunity to enter the workforce. In general, women aged between 16 and 25 years constitute up to 90 per cent of the labour force of EPZs.

54. **Creation of linkages.** The effectiveness of EPZs for the achievement of long-term economic objectives, including that of improving the overall environment for private sector and export development, largely depends on the extent of linkages created with the host economy and of their contribution to the upgrading of technology and skills. Critics of EPZs often cite the low level of linkages between the mainly foreign, export-oriented firms located in the EPZs and the local economy. The main economic links are through the services provided for the EPZs and their personnel, and through the consumption of local goods by EPZ personnel. There is an inherent bias in EPZs, including the enclave nature of most EPZs, which hinders the creation of linkages. Special concessions on imported goods, the unavailability of high quality local inputs at internationally competitive prices, a lack of natural resources and close production ties between EPZ subsidiaries and home country parent firms all serve to inhibit the spread of backward linkages. Thus the degree of backward linkages is closely related to the level of industrialization of the country. The linkages are greater in economies where the gap between firms inside and outside the EPZs is narrowing. As local firms develop the capacity to manufacture intermediate goods for EPZ companies, they are encouraged by being granted incentives as indirect exporters, facilitating backward linkages. Further, local firms could be spurred to greater efficiency by a gradual exposure to competition from goods produced by EPZ firms.

55. In the final analysis, the promotion of linkages is a matter of government policy towards EPZs, i.e. whether they see EPZs as part of an overall effort to create an environment conducive to export development or as an exception to overall policy. Experience shows that EPZs tend to be successful when viewed as part of a larger process of reform. 22/ Seen in this light, the Government can encourage local firms, for example by means of fiscal incentives, to become suppliers of competitively priced intermediate goods to EPZ firms, thus gradually extending some of the privileges of EPZ firms to those outside. This is the case in Sri Lanka, where the Government has encouraged the establishment of textile mills in order to furnish fabrics to firms in the EPZs. Likewise, in Shannon, Ireland, through the "Match Maker Programme", aimed at bringing together EPZ firms and local SMEs, the economy outside the zone has gone rapidly, particularly in terms of exports, cutting sharply into the share of exports from the Shannon free zone. The latter has dropped from 40 per cent of total national exports in the early 1960s to something like 3-4 per cent in 1992. Further, in Togo, the EPZ legislation is

based on a functional rather than a geographical approach, granting the EPZ privileges not only to EPZ enterprises but also to qualifying firms outside the zone. Firms qualify for EPZ status provided that at least three quarters of their output are exported directly or indirectly, 80 per cent or more of their employees are Togolese nationals and they use mainly local raw materials. These provisions benefit SMEs established outside the zone; in addition to producing export goods, they primarily produce inputs for other exporters or provide services which complement and facilitate the activities of export firms, thus helping to forge linkages between various industries. 23/

56. **Technology transfer.** As regards the transfer of technology and skills, it is rather limited and essentially takes place within the zone, especially in joint ventures between TNCs and local firms, in such areas as modern management techniques, work organization, export marketing and export finance. Further, progressive automation and more sophisticated processes, as well as a growing number of local managers and technicians, are being observed in some EPZs. Moreover, local workers in the EPZs, especially those located near to urban centres, can impart their knowledge to local firms upon leaving them. The "demonstration" effects may well be one of the most important contributions of EPZs to the local economy.

57. **Lessons learned.** An EPZ can provide an additional instrument of export policy; however, it is not a substitute for economy-wide reform. For its success (and the success of longer-term reforms) investor confidence is crucial. This requires, among other things, a healthy investment climate, an active local business community, good infrastructure and an adequate labour supply at the right price and skill level. These basic considerations probably carry more weight in attracting foreign investment than "cosmetic" financial incentives offered by EPZs, especially for long-term investors. Investors also require a stable policy towards EPZs, consisting of clear, simple regulations so that they have a precise idea of their rights and obligations. Minimum contact with government bureaucracies is preferred; ideally a "one-stop" agency could be set up to handle simplified administrative procedures. Legislation pertaining to EPZs should be formulated so as to be clear for the investor. This could be done by incorporating all EPZ legislation into one country-wide law, or by having one law governing specific zones, as in China and Malaysia.

58. Where tax holidays are used, these must be transparent to prevent abuse. In some cases where companies were granted tax holidays for a certain period, they simply changed their names after the period expired in order to receive another tax holiday. Tax holidays can be used creatively for the greater benefit of the host country, for example for the development of new products. The effects of financial incentives have to be carefully evaluated in order to make them effective. Some experts have pointed to the necessity for a certain degree of coordination among EPZ developers to avoid unnecessary costs by excessive competition through fiscal and other incentives.

59. Customs clearance is a crucial factor for EPZ firms who have to be able to move their goods quickly. Firms locate in an EPZ for various customs privileges. Close cooperation between zone developers and customs authorities from the start can greatly help efficiency of customs clearance and thus the

success of the zone. The head of customs founded the first Syrian EPZ, which was subsequently administered by customs authorities. In Shannon, Ireland, a senior customs officer located inside the zone advises incoming firms on procedural and administrative matters. Through close cooperation among all concerned and computerization of customs procedures, the Grupo Bermudez in Mexico can clear trucks from their zones in 15 seconds. Indeed, some companies in their zones benefit from such efficient customs clearance that they actually have zero inventory. In Sri Lanka, in-zone customs services are provided and goods are not delayed in transit.

60. Good zone management is critical to the success of an EPZ. Zone managers need to carry out regular surveys in order to evaluate the different services provided and to be able to respond to the changing needs of their clientele.

61. The choice of location is another important factor. Ideally, an EPZ should be located near a port or airport, close to major industrial areas. There must be adequate, easily-accessible transportation (sea, air and road). In addition, the EPZ must have all the necessary utilities, such as electricity, water, sewage treatment and telecommunications. Several EPZs have failed due to poor location, resulting either in isolation from urban centres or inflated development costs, because of the need to construct basic infrastructure, notably in the Bataan EPZ in the Philippines.

62. A great advantage of EPZs, especially for SMEs, is the availability of ready-built factories that save the amount of capital tied up in start-up costs. Care must be taken not to over-estimate the number of future clients. This could lead to huge costs for the EPZ, which might never be recovered. It is better to research the needs of potential clients and build a few factories to suit a variety of needs (different sizes and layouts, as well as leaving empty lots for those who prefer to build their own factories) and then expand as the EPZ grows. One particular project called the Nogales Shelter Plan in Mexico provides factory space, workers, personnel and customs assistance. The client pays a fee (US$ 1.50 in 1992) per hour of work time. The contract allows the client to leave after six months with one month's notice. This considerably reduces the risk for new clients, allowing them to try out an EPZ location before committing themselves to a long-term investment.

63. EPZs are distinguished by the range of services provided. Some zones provide recruitment services to short-list workers and technicians, so that investors do not need to spend their time and money interviewing thousands of applicants. Others provide housing for EPZ staff and transportation to and from work. Some zones also offer child-care facilities, security systems, medical services, on-site banking, computer services, maintenance services, printing services and libraries. Nevertheless, it must be stressed that these services are secondary in importance to basic zone conditions (good management, efficient customs, adequate infrastructure) which are themselves superseded by the political and macroeconomic environment in the host country. But the range of services can make a difference where similar conditions exist.

64. Zone promotion and marketing is another crucial factor in the successful development of an EPZ. Initial research into the needs of potential investors allows zone developers to target future clients. The marketing of an EPZ is firstly a question of marketing the host country, which is why a sound economic and political environment is necessary. For instance, in Mexico, different zone managers pool together to "sell" the country as a desirable place to invest. This is particularly important when targeting developed-country SMEs which have never made a foreign investment and which are looking for the most stable place to invest. Zone investors then market their own particular zones based on the services they offer. Here, schemes such as the Nogales Shelter Plan of privately-run zones may make an important difference. Zone promotion can, however, be an expensive operation (approximately US$ 1 million/year in the average private Mexican zone) and is therefore not worthwhile if carried out in half-measures. Professional marketing people should be used for the general campaign, while zone managers should be involved in cultivating personal contacts with potential clients.

65. The debate over private versus public development and management of EPZs has emerged in many countries. Private management is considered to be desirable on the grounds that it is motivated only by commercial considerations, for example, in the choice of location. Privately-run zones are also in a better position to implement an effective promotion package to market the zone. In general, they are less bureaucratic, allowing them to be more flexible and innovative in their approach. However, a successful EPZ depends on close cooperation with the Government in terms of customs and investment policy. Asian zones are almost always public, but they are run commercially, with profit-making as the main consideration, and they enjoy a high degree of autonomy. Most experts have pointed to the desirability of privately-run EPZs or public EPZs run as private ventures, as in Singapore and Hong Kong.

66. **Future development of EPZs.** Some of the trends in EPZ policy can already be seen. There is more emphasis on promotion and marketing which in turn engenders a wider range of services offered by EPZs. Close cooperation between zones and Governments, especially in terms of customs, will lead to better-defined economic policies regarding EPZs. Such policies should also cover the economy as a whole, with the aim of increasing both backward and forward linkages with the local economy.

67. In many countries, the future of EPZs is heavily influenced by the fact that they are part of a broader economic reform. Ideally, the need to encapsulate policies favourable to exporting and private enterprise in a geographically-bound area will disappear, so that such policies will become available to firms outside the zone, benefiting the economy as a whole. Already in countries like Sri Lanka and China, entire territories and provinces have been declared EPZs or SEZs, eroding the limited (and limiting) geographical notion of EPZs. Once the notion of EPZs surpasses geographical boundaries, the remaining physical infrastructure will likely evolve into industrial estates for the industries that once dominated the EPZs. In the Asia-Pacific region, the concept of Subregional Economic Zones (SREZs) is being discussed, further weakening the geographical boundaries of the notion of EPZs.

68. As EPZs mature and the local industry develops, linkages between the EPZ and local firms take place. For example, at its inception in the 1970s, the EPZ in Mauritius was dominated by the textiles industry. Vertical integration subsequently took place (for example, local manufacturing of buttons, boxes, etc.). More advanced, high-technology industries then moved in, introducing more capital-intensive industries and bringing greater technological benefits to the local economy. Mauritius can now afford to be more selective as to the type of industries it allows into its EPZ. This type of development facilitates the development of linkages with the local economy, as well as technological and industrial upgrading. Partly due to this "natural lifecycle" of EPZs and partly due to industrial changes, the nature of EPZ industries is likely to evolve from textile and garments and electronics assembly to higher technology and service-oriented industries. In Jamaica, EPZs are involved in data processing and telemarketing services. The Shannon free zone is getting involved in aircraft maintenance, Mauritius in ship repair. Other exploitable activities include off-shore banking, insurance, aircraft leasing, even educational services and agro-business. In China's SEZs, investment is encouraged in anything from tourism to agriculture to real estate.

69. Consequently, cheap labour will decline in importance as new industries take off. More emphasis will be placed on educated, skilled labour capable of operating high-technology machinery. Governments will need to develop their educational strategies accordingly. In addition, with the decline of cheap labour, other factors such as location (in terms of access to expanding markets), advanced telecommunications and infrastructure will become more important for firms in their choice of EPZs.

C. Rural export production

70. The experience of rural township enterprises (RTEs) in China provides an interesting example of how SMEs can contribute to both rural industrialization and export development. RTEs are very much based on local initiatives and are run by individuals, mostly farmers, households and cooperatives in the rural areas. In 1994, the number of RTEs in China stood at 18 million, most of them in industry, up from 1.3 million in 1982. The number of employees stood at 112 million in 1993, surpassing the number of State employees. RTEs have been a significant source of employment for surplus rural and urban labour, constituting over 60 per cent of farmers' income. The industrial output of RTEs in 1993 accounted for 47 per cent of total industrial output. RTEs took seven years to achieve a level of industrial output which State-owned enterprises had taken 31 years to reach. 24/

71. RTEs have changed the structure of the rural economy, providing jobs to much of China's 1.2 billion population, of which over 70 per cent is located in the countryside. These jobs represent not only full-time employment, but perhaps more importantly, part-time positions that complement the dominant rural occupation of farming. RTEs, by fostering rural industrialization, have facilitated the gradual transition from agriculture-based production to industrial-based production. Furthermore, by providing an industrial alternative to agriculture, they encourage smaller, efficient-scale farming, rendering the agricultural sector more profitable. The principle of "leaving the soil but not the rural area, entering factories but not the cities" has

been implemented through RTEs, going a long way towards solving the problem of more workers and less farmland in China and of rural migration to urban areas. RTEs have also increased their share of State and local income, supplying as much as 70 per cent of the local revenue in some cases. RTEs also contribute to the social development in rural areas by making important contributions towards rural education, welfare and construction.

72. **Contribution to export development**. RTEs play an important role in China's exports. In addition to favourable tax regulations and financial support, the Government also encourages the creation of linkages, such as subcontracting arrangements, with export-oriented firms, including those in the special economic zones. Their export earnings jumped from 4.3 per cent of the national total in 1984 to 45 per cent in 1993. By the end of 1992, there were 84,750 export-oriented RTEs, concentrated in garments (89.7 per cent of total exports), arts and crafts (63.7 per cent), silks (54 per cent), chemical products (53.2 per cent) and foodstuffs (35.2 per cent). 25/ The growing presence of RTEs in exporting has also been accompanied by a parallel rise in foreign investment which is encouraged through the provision of various incentives as a means of increasing exports, acquiring international managerial skills and techniques and improving product quality.

73. **The Spark programme.** Conservative estimates reveal that 50-60 per cent of RTE technology is obsolete and needs to be replaced. Only 10-20 per cent of RTE technology is relatively modern. 26/ In order to fire up the rural economy through science and technology, the Spark programme has been introduced which derives its name from the Chinese proverb "A single spark can start a prairie fire". From its inception in 1986, it has developed a range of technical equipment for RTEs and has trained 8.9 million technical and managerial personnel for various sectors of the rural economy. The success of the programme is largely attributed to its basic policy guidelines. One, all projects must be formulated according to market demand. Before any project is sponsored by the programme, a market survey and feasibility study must be carried out. This policy has led to a high rate of successful Spark projects (95 per cent out of 20,000 projects). Two, in terms of funding, the Spark programme relies primarily on bank loans and self-collected funds (among local enterprises and other entities) rather than on Government and foreign funding. In 1992, self-collected funds accounted for over 50 per cent of total funding, government funding less than 10 per cent and bank loans 40 per cent. 27/ Three, strict criteria for sponsoring projects are applied. The technology created must be a leader in its field, suitable to local conditions and resources, and must yield relatively quick returns. Four, the Spark programme aims to train qualified personnel capable of handling the new technology in the rural areas. To this end, it has set up numerous technical and management training courses and encouraged the flow of experts from scientific institutes to the rural areas. Through these strict guidelines, the Spark programme has made a significant contribution to rural development, especially in the promotion of RTEs by helping them to overcome the obstacle of backward technology.

74. **Lessons learned.** One of the principal factors for the success of RTEs is that they take advantage of the natural economic progression from agricultural to industrial production and of the surplus labour that this transition creates. RTEs exploit the entrepreneurial spirit among farmers by providing

them with the opportunity to raise their standard of living away from the fields, but still allowing them to work in the rural areas. Improving management and the implementation of rules and regulations governing RTE standards, especially in quality control, are essential. Greater efficiency is promoted by phasing out bankrupt RTEs or by switching them to other industries. The official encouragement of "after-work arrangements", whereby scientists and engineers in the cities make a second career in RTEs by becoming a consultant or a partner in a RTE (using their specialized knowledge as an investment) and the use of retired scientists and engineers mean that RTEs can have access to a wide range of technical expertise at a reasonable cost. There is close cooperation between RTEs and educational centres in order to recruit trained personnel and to ensure that existing employees are sufficiently trained. Exposing them to export markets and encouraging the development of their linkages, including subcontracting arrangements, with exporting enterprises have been important factors in their export success. This has been helped by foreign investment, which has brought about such changes as an emphasis on quality rather than quantity and the use of higher technology in production and of better management practices.

75. **Future development of RTEs.** In addition to favourable Government tax regulations and financial support, RTEs themselves are instituting new policies to improve their situation. There is an increasing emphasis on the clustering of enterprises and on product specialization by firms - in other words, the creation of industrial districts - in order to improve quality and efficiency, reduce costs and to attract foreign investment. More market elements will be introduced over Government regulations, resulting in fiercer competition and in increased demand for skilled management and trained personnel. RTEs are more and more inclined to adopt a shareholding system as a means of mobilizing financial support and enhancing employee initiative. Perhaps the most spectacular push for the development of RTEs is in the domain of scientific and technological advancement in order to replace out-of-date production techniques and to speed up the pace of product development and modernization.

D. Growth triangles

76. Growth triangles are economic cooperation zones that straddle national boundaries. The underlying concept of growth triangles is that geographically contiguous areas of neighbouring countries can exploit their complementarities in order to gain a competitive edge in producing for export. In this way, subregional economic or export zones are being forged. They differ from national EPZs in that they can provide for a better synergy of the comparative advantage of each participating country. While the more advanced regions or their enterprises provide capital, technology and skills, the less advanced regions provide land, other natural resources and labour, both skilled and unskilled. The benefits to them will reflect the returns to the different factor inputs. These include inter alia job generation, the creation of inter-firm linkages, skill development and technology transfer and externalities for the economy as a whole. For a firm, it can locate its various activities in different locations within the triangle, for example, R & D activities in one part (to take advantage of the technological and physical infrastructure available) and production activities in another location (to benefit from low-cost labour). Since their success requires the

reduction or removal of barriers to the mobility of people, products, resources and money across national boundaries, political will is needed. In fact, they are being viewed not only as instruments of economic policy but also of foreign policy and national security. 28/ The experience with growth triangles in South-East Asia indicates that, while the political aspect has not always been easy, it has not proved to be a real obstacle. For SMEs, which are likely to benefit from growth triangles, the advantage is that they can internationalize without having to leave the local area. Investments in the growth triangles in East Asia come largely from within the region itself.

77. While the experience of growth triangles is still fairly recent, they are increasingly linking economies in the East Asian region through the creation of enterprise, investment and trade linkages. Examples of such growth triangles, being developed or discussed, include one linking Singapore, Malaysia's Johore State and Indonesia's Riau Islands; the East ASEAN Growth Area linking Brunei, the east Malaysian States of Sabah and Sarawak, Mindanao and Sulu in the southern Philippines and Sulawesi and Manado in Indonesia; another growth triangle linking southern Thailand, Malaysia's four northern states and Sumatra of Indonesia; a "quadrangle" linking Cambodia, Myanmar, Laos People's Democratic Republic, Thailand and parts of southern China; and the Greater South China Economic Zone, centred on Hong Kong and embracing also China's Guangdong and Fujian Provinces and Taiwan, Province of China. At least five other growth triangles in the East Asian region have been discussed, including, among others, the Yellow Sea and Japan Sea Economic Zones.

Notes

1/ See Final Report of the Ad Hoc Working Group on Investment and Financial Flows, p.5.

2/ See: Government of Turkey: Country contribution to the Ad Hoc Working Group on the Role of Enterprises in Development. Geneva, 1995, p.7.

3/ See: Hall, Ch: The globalization of economic activity and SME development in the Asian economies; evidence and policy issues. Paper presented to the Twenty-first International Small Business Congress, Jakarta, 18-21 September 1994.

4/ See: Hall, op. cit.

5/ See: UNCTAD: Small- and medium-sized transnational corporations. New York, 1993.

6/ See ITC: Constraint analysis of exporting SMEs. The experience of selected developing countries of the Asia-Pacific region, (ITC/DTC/94/2091), Geneva 1994.

7/ See Kim, L./Nugent, J.B.: Korean SMEs and their support mechanisms: an empirical analysis of the role of government and other non-profit organizations. Washington, D.C.: World Bank, 1994; Berry, A./Levy, B.: Indonesia's small and medium industrial exporters and their support systems. Washington, D.C.: World Bank 1994.

8/ Some examples of this type of institution are: Commonwealth Development Corporation (United Kingdom), German Finance Company for Investments in Developing Countries (Germany), Finnish Fund for Industrial Development Cooperation (Finland), Netherlands Development Finance Company, etc. See UNCTAD: Small and medium-sized transnational corporations, op. cit.

9/ Some examples include Overseas Private Investment Corporation (United States of America), Shoko Chukir Bank (Japan) and the Small Business Finance Corporation (Japan), etc. See UNCTAD op. cit. p. 154.

10/ Some examples include the Canadian International Development Agency, Association pour la Promotion et le Développement Industrial (France), German Society for Technical Cooperation (GTZ), etc. See UNCTAD op. cit. p. 154.

11/ Opitz, St.: Export promotion in the context of technical cooperation. In Intereconomics, Vol. 29, No. 3, Hamburg 1994, p. 139 ff.

12/ See Biggs, T. et al.: Africa can compete. (World Bank Discussion Papers, no. 242).

13/ See: Amin, A: "The potential for turning informal economies into Marshallian industrial districts". In UNCTAD Technological dynamism in industrial districts, p. 56.

14/ See: Schmitz, H./Musyck, B.: Industrial districts in Europe: Policy lessons for developing countries. In: World Development, Vol. 22, No. 6, p. 904.

15/ See Liew, Mun Leong: "Industrial districts in developing countries" in UNCTAD: op. cit. p. 275.

16/ See: Schmitz H./Musyck, B.: op. cit, p. 904.

17/ See: Nadvi, op. cit., p. 234.

18/ Van Dijk, op. cit., p. 30.

19/ Amin, op. cit., p. 67.

20/ See: UNCTAD: World Investment Report 1994. New York/Geneva 1994, p. 189.

21/ See: UNCTAD: Export processing zones: Role of foreign direct investment and development impact. (TD/B/WG.1/6) Geneva 1993, p. 16.

22/ See Linn, J.F./Wetzel, D.L: Finance, trade and development; "What have we learned?" In Tanzi, Vito, ed.: Fiscal policy in open developing countries.

23/ See: Communication du Ministre de l'Industrie et des Sociétés d'Etat sur l'implantation d'une Zone Franche Industrielle au Togo au Corps diplomatique à Lomé le 8 août 1989.

24/ See Wang Jinzhen: Current situation of Village and Township Enterprises in China and their development tendancies, Table 1.

25/ See Wang, op. cit, p. 4.

26/ See Song Zehan: A new approach to rural industrialization; relevant policies of China's Spark programme, in "SME towards 2000" p. 231.

27/ Song, op. cit., p. 232.

28/ See: Ramos, F.V.: Cross-border "Growth Triangles" promote prosperity in East Asia. In: International Herald Tribune, 30 November 1994, p. 4.